INTRODUCTION

On Monday, February 3, 2003, the Assembly Committee on Revenue and Taxation held an informational hearing to explore the history and mechanics of the Manufacturers Investment Credit (MIC) and to learn how businesses have used it. The hearing was held in Room 126 of the State Capitol in Sacramento, California, from approximately 1:45 p.m. until approximately 4:10 p.m. Approximately 75 people attended the hearing.

Six of the committee's members heard testimony from 15 witnesses. Members who participated in the hearing included:

Assemblymember Ed Chavez, Chair
Assemblymember Mark Wyland, Vice-Chair
Assemblymember Tom Harman
Assemblymember John Laird
Assemblymember Mark Leno
Assemblymember Joe Simitian

The hearing was designed to explain the mechanics of the MIC, hear from businesses how they use the MIC during their decision-making process, and investigate whether there are administrative issues surrounding MIC claims that warrant further study. This final report contains the committee staff's summary of the testimony offered and recommendations advanced during the hearing. This report also reprints the background paper written by staff before the hearing, reproduces written testimony and documents submitted by the witnesses, and reproduces written testimony offered by the public (refer to separate sections).

THE WITNESSES

Mr. Chris Micheli, Carpenter Snodgrass & Associates*

Mr. J. Brian Putler, Director, Legislative Services Bureau, Franchise Tax Board

Mr. John Abbott, Tax Counsel IV, Appeals Section, State Board of Equalization*

Mr. Phil Spilberg, Director, Economic & Statistical Research Bureau, Franchise Tax Board*

Mr. Dave Hayes, Manager, Research & Statistics, State Board of Equalization*

Mr. Richard Holden, Chief, Labor Market Information Division, Employment Development Department *

Mr. Mark Ibele, Principal Fiscal and Policy Analyst, Legislative Analyst's Office*

Ms. Dorothy Rothrock, California Manufacturers & Technology Association*

Mr. David Goodreau, Small Manufacturing Association of California

Mr. Ray Rossi, Director, External Tax Affairs, Intel Corporation*

Mr. Herb Schmidt, Vice President, Public Affairs, Robert Mondavi Winery

Ms. Jean Ross, Executive Director, California Budget Project*

Mr. E. Scott Ewing, Senior Manager, Multistate Tax Practices Group, Deloitte & Touche

Ms. Jim Brandes, Income Tax Manager and Audits, AMD*

Mr. Geoffrey S. Way, Tax Counsel, Legal Branch, Franchise Tax Board

* Written material presented by the individual is contained in the "Materials Submitted" section of the Summary Report.

INFORMATION PRESENTED

The hearing was presented in two segments: 1) an overview of the MIC, and 2) a presentation of how the MIC is working, offered by invited witnesses representing businesses, manufacturing associations, tax practitioners, public interest groups, and tax agencies.

Segment 1:

Overview of the MIC: Much of the testimony presented during the introductory segment of the hearing mirrored information contained in the background paper prepared for the committee by the Legislative Analyst's Office. Rather than duplicating that information, the summary below addresses only those comments made by witnesses that augment, rather than duplicate, information in the Legislative Analyst's Office report.

Phil Spilberg, FTB: The MIC cost the state (or saved taxpayers, depending upon one's perspective) $457 million in 2000, the most recent tax year for which data are available. The amount of credits earned in any given year is much greater than the amount claimed. Furthermore, in any given year, MIC claims are comprised of credits carried forward from prior years and credits earned in the year in which they are claimed. For example, in the 2000 tax year, corporations carried forward $756 million in credits and earned $519 million in credits, yet claimed only $410 million in credits (the remaining $47 million in credits were claimed by businesses filing under the Personal Income Tax Law).

Dave Hayes, Board of Equalization: Mr. Hayes' information was more limited regarding the MIC's sales and use tax exemption than that available for the MIC franchise and income tax credits, because sales tax exemption information generally is not tracked.

However, Mr. Hayes' presentation estimated that the sales tax exemption component of the MIC cost the state/saved taxpayers an average of $6 million per year between 1994 and 1998 (the most recent years for which data are available).

Richard Holden, Employment Development Department (EDD): Mr. Holden described EDD's role in providing an annual report to the Legislation reporting on the level of specific manufacturing jobs in California. He stated that EDD would be unable to provide the required employment information in the future because the classification system required to be used by the statute [the Standard Industrial Classification (SIC) code] is no longer used to gather employment data. For purposes of gathering employment data, the SIC has been replaced by the North American Industry Classification System (NAICS). Due to this change of how businesses report employment, Mr. Holden recommended that the MIC statutes be amended to reflect NAICS classifications. He acknowledged that it will require significant work to map SIC codes to NAICS codes, because the two classification systems are not parallel.

Assemblyman Ron Calderon, 58th Assembly District: Assemblyman Calderon addressed the committee about his bill, AB 122, that proposes extending the MIC to January 1, 2006, and to subsequent years if manufacturing employment targets are reached and maintained. He described the MIC as an effective economic stimulus offered by the State to manufacturing businesses that operate in California.

Mark Ibele, Legislative Analyst's Office (LAO): Mr. Ibele briefly summarized the report he had prepared for the committee regarding the MIC and then added additional comments for the benefit of committee members. He asserted that the LAO does not have a position on whether the MIC should be allowed to sunset, but suggested that fiscal effect alone might not be the best way to evaluate tax expenditures such as the MIC, because the effectiveness of the MIC can never be fully measured. He supported this statement by commenting that, in general, there has been no study that proves any economic effectiveness in investment tax credits.

Mr. Ibele suggested that the MIC should be evaluated outside of the immediate fiscal effect. He identified numerous factors that could be helpful to an evaluation to include: the impact on the overall business climate, i.e. stability of the balance of manufacturing; services and financial services; financial investment incentives; compensation for other costs of doing business; relief from double taxation; inequitable tax advantages; comparison of creation or relocation; and actual impact on business decisions.

Mr. Ibele also noted that the MIC can be very important to certain firms making business decisions, but that its individual impact varies depending on the particular situation. For example, one business might be greatly influenced by the MIC, while another business in the same industry might make its business decisions without regard to the presence of the MIC. Mr. Ibele also suggested various alternatives for further study, including a view toward investigating the impact of the MIC on capital intensive industries and on geographical relocation issues.

Segment 2:

MIC Usage: The second segment of the hearing involved testimony from representatives of specific businesses as well as industry associations.

Business' Perspective: Speakers representing the business community stated that the MIC:

- Represents an effort to counter some of the negative aspects of doing business in California (including high electricity rates);
- Encourages manufacturing in California with a multiplier effect per manufacturing job of approximately 250%;
- Helps counter the existing "perfect storm" working against manufacturers in California -- foreign competition, supply chain consolidation, and lack of skilled labor;
- Helps companies lower costs, increase capacity, modernize facilities, and expand products; and
- Encourages companies to expand in California rather than in other states or in other countries.

These speakers also asserted that the MIC more commonly influences decisions regarding *where* to invest, rather than *whether* to invest. One participant noted that if one ignored the tax incentives offered by various jurisdictions in siting manufacturing plants, he or she would have to answer to shareholders regarding why such an important consideration were not considered.

Jean Ross, California Budget Project: Ms. Ross questioned whether the MIC was truly essential to business decisions, citing that less than 9% of manufacturing businesses have claimed the credit. She identified the lack of independent, objective means to evaluate this issue and suggested that investing the credits granted under the MIC might yield a bigger impact on the business environment if the same funds had been invested in California infrastructure. She also questioned the positive effect of increased capital investment on employment and pointed out that approximately 25% of the MIC claimed through tax year 2000 had been claimed by oil companies, representing an industry with declining employment. Ms. Ross stated that the lack of information available could be eliminated if taxpayers who claimed the MIC could waive their respective rights to confidentiality.

Ms. Ross outlined several options, including leaving the MIC as-is, cap the amount of the MIC available to any particular taxpayer; tie the MIC to specific levels of employment growth; and, introduce requirements on disclosing information by taxpayers claiming the MIC, including of levels of employment.

Implementation Concerns of Tax Practitioners: The panel included one representative from each of public accounting, private industry, and the Franchise Tax Board.

One panelist stated his practice largely involved representing clients in matters involving the MIC. He stated that the MIC was used by companies ranging from "Fortune 100" to "mom and pop" operations. He also stated that the MIC was claimed as current credits, as well as being claimed as refunds of tax paid. In fact, approximately one-third of his practice involved representing taxpayers with refund claims.

One panelist stated that the MIC was a factor in decisions to locate in California, indicating that the MIC impacted matters of interstate, as well as international, competition. He also stated that problems included a large percentage of audits of taxpayers claiming the credit, followed by subsequent administrative appeals before the Board of Equalization.

Implementation issues were also revealed by statistics on the audit process. Despite general information on well-published decisions involving the MIC, approximately 5% of the companies that claimed the MIC were audited and, out of more that 11,000 claims filed, less than 50 cases remained unresolved.

Public Comment

Mr. Fred Noteware, Silicon Valley Manufacturers Group, stated that the MIC was a positive factor in encouraging growth. He also stated that as manufacturing sites increase, there is a concurrent increase in support services.

Lenny Goldberg, California Tax Reform Association, stated that many of the promises made when the MIC was enacted, including maintenance of manufacturing jobs in excess of the January 1, 1994 level, have not been maintained. He categorized his position as not one for or against the MIC; rather, he questioned whether the MIC was the best way to spend $450 million per year.

Charlie Ray, contractor in the Central Valley, stated that the MIC was a positive factor for business decisions in which he had participated.

Kathy Hatch, AeA, testified that an extension of the MIC was a pivotal piece in any stimulus package for manufacturing industries.

Julie Puentes, also identified the MIC as critical to stimulate the manufacturing industry.

SUMMARY AND RECOMMENDATIONS

Chairman Chavez concluded the hearing be restating that definitive answers or recommendations were not the goal of the hearing. However, testimony of several witnesses clearly reveal a problem with the statutory trigger mechanism that requires the

Employment Development Department to compile employment data using the SIC codes. It is clear that any correction of or adjustment to this requirement will require legislative action.